16.05 Interim Financial Reporting

Companies that issue annual financial statements typically issue interim reports on a **quarterly** basis as well. In general, the application of **generally accepted accounting principles** to a report covering three months will be no different than for a report covering one year, since an interim period is an integral part of the overall year. Timeliness is emphasized over reliability. These statements should be marked "unaudited." As a result (**ASC 270):**

- **Revenues** are recognized in each quarter as earned and realized (for example, estimates must be made each quarter when applying the percentage-of-completion method of construction accounting to determine the profit in each period).
- **Expenses** are matched to each quarter (for example, a property tax bill covering an entire year must be allocated equally to the four quarters).
- **Accounting Changes** made in an interim period are to be reported by retrospective application.

For example, assume a client received an annual rental payment of $300 from a client on 1/2/X1 and paid a $100 property tax bill covering all of calendar year 20X1 on 3/15/X1. The effects of these items on the interim reports in the 20X1 are:

Quarter	**1st**	**2nd**	**3rd**	**4th**
Rent income	75	75	75	75
Property tax	(25)	(25)	(25)	(25)

One item that may need special consideration is the provision for income taxes. When preparing an annual report, the company already knows its taxable income for the year and can compute its income tax provision with full knowledge of the applicable tax rates and available tax credits.

When computing income taxes at an interim date, however, the company must make an estimate of the **effective annual tax rate** that it believes will be applicable for that entire year. This should take into account estimates of total taxable income for the year and any tax planning strategies the company plans to adopt during the year.

The estimate of the effective annual tax rate should be updated at each interim date, and the provision for income taxes in later quarters will be based on the current estimated rate applied to cumulative income reduced by provisions reported in early periods.

For example, if a client has income of $100 in the first quarter of 20X1 and expects the effective annual tax rate for all of 20X1 to be 25%, then the provision for income taxes in the first quarter will be $100 x 25% = $25. If the client has an additional $150 of income in the second quarter, and revises their estimate of the effective annual tax rate for all of 20X1 to 30%, then the provision for income taxes in the second quarter will be calculated as follows:

Income in 2nd quarter of 20X1	150
Income in 1st quarter of 20X1	100
Income for 6 months ended 6/30/X1	250
Expected effective annual tax rate	30%
Income taxes for 6-month period	75
Less: Amount reported in 1st quarter	(25)
Income tax provision in 2nd quarter	50

Another item requiring special handling on interim reports is **inventory.** The use of inventory estimation techniques is permissible for interim reports. A special problem, however, involves fluctuations in inventory values at interim dates.

Since interim periods are integral parts of the entire year, they must be computed in a manner that will result in consistent presentations with the full year. A company sometimes experiences declines in inventory values at interim dates that are **expected to be recovered** by year-end. In these cases, inventory should **not** be written down to market at the interim date. On the other hand, if a decline in value is not expected to be recovered before year-end, then the inventory should be written down.

For example, assume a client has suffered a substantial drop in the replacement cost of their inventory at the end of the first quarter, but believes these values will recover before the end of the year. The decline in market will not be reported in the first quarter. If the client is incorrect, and values do not recover by the end of the year, the decline will be reported in the fourth quarter.

On the other hand, assume a decline occurs in the first quarter, and the client **does not believe prices will recover** by year-end. They will write down the inventory to market in the first quarter. If the client is incorrect, and values recover in the third quarter of the year, the increase in market will have to be reported in the third quarter to offset the decline reported in the first quarter. Any increase in value in the third quarter that exceeds the decline reported in the first quarter is ignored, since inventory is not valued at market when it is higher than cost.

To Summarize:

- Property taxes, bonuses, depreciation – allocate to all quarters
- Inventory losses – in that quarter
- Major expenses - in that quarter, unless benefit future quarters then allocate.
- Discontinued operations – in that quarter
- **Income tax expense** is estimated each quarter using the rate expected for the entire year.

SEC Reporting Requirements under Regulation S-K

Quarterly report (Form 10-Q) provides quarterly information similar to that in the 10-K but in less detail. Quarterly financial statements are **reviewed** by public accountants. The company files three Form 10-Qs every year and the Form 10-K contains the quarterly results for the fourth quarter. The Form 10-Q must include the following financial statements.

- An interim balance sheet as of the end of the most recent fiscal quarter, and a balance sheet as of the end of the preceding fiscal year. It will include only major captions and items representing less than 10% of total assets that have not changed by more than 25% may be combined with other items.
- Interim statements of income for (1) the most recent fiscal quarter, (2) for the period between the end of the preceding fiscal year and the end of the most recent fiscal quarter, and (3) for the corresponding periods of the preceding fiscal year. It will also include only major captions. Items representing less than 15% of average net income for the 3 most recent fiscal years that have not changed by more than 20% when compared to the corresponding preceding fiscal period's statement of income may be combined with other items.
- Interim statements of cash flows for (1) the period between the end of the preceding fiscal year and the end of the most recent fiscal quarter, and for (2) the corresponding period of the preceding fiscal year. The statement is abbreviated and reports a single figure for net cash flows from operating activities and only reports individual changes from investing and financing activities if they exceed 10% of average net cash flows from operating activities for the preceding 3 years.
- The statement of changes in equity may also be presented.

Disclosures are limited to those needed to avoid the financial information being presented from being misleading. Information that was included with the most recent annual financial statements that have not changed significantly may be omitted.

Form 10-Qs are due **40 days** after the end of the fiscal quarter for accelerated and large accelerated filers (**45 days** for all other registrants including non-accelerated filers and small reporting companies)